

OVER TAXED!

OVERHAUL OR TUNE UP?

BOLD OR BANDAID?

Presentation of:
Laurie G. Lachance
State Economist

To:

Greater Portland Chambers of Commerce
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Laurie G. Lachance
Maine State Planning Office
184 State Street
#38 State House Station
Augusta, ME. 04330
Tel: (207) 287-1479
Email: laurie.lachance@state.me.us

OVERTAXED? Overhaul or Tune-up?

Presentation of Laurie G. Lachance – State Economist
To: Greater Portland Chambers of Commerce – 3/12/02
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Eco-Eco – 4/12/02
Mid-Maine Chamber – 4/11/02
Growth Council Red Flag Session – 4/29/02

INTRO:

Good afternoon, it is a pleasure to be here to talk with you about Maine's tax structure.

Today we are here to examine the Maine Economic Growth Council's Indicator #15, a measure that has the dubious distinction of being awarded a Red Flag.

Before we go too far down this road, it is important to highlight, right up front, that this indicator is one piece of the puzzle that helps to characterize the health and vitality of Maine's economy. No one indicator, alone, tells the whole story, but taken together, a picture comes into focus, illuminating both strengths and trouble spots.

In March, I was asked to address the Policy Soundings forum put on by the Greater Portland Chambers, and examine if Maine's tax structure needed a dramatic overhaul or a minor tune-up. Our discussion in Portland that morning fanned the flames of statewide debate. Because it is an election year and tax reform is, and should be, a central issue, I've been asked to share that presentation with you today.

But before I do, I would like to remind you that I reserved the right to grow smarter and so I am refining my message to incorporate what I'm learning and I welcome your thoughts at any point.

SLIDE 1: Comic – State Tax System

I opened the Maine Sunday Telegram a while back and thought this comic was quite timely.

This Big Bird – labeled "State Tax System" – talking to the State Bird saying, "Who are you calling a DoDo!" and the little guy on the branch says, "You haven't exactly kept up with the times, my little Chickadee"!

The discussion of and discontent with Maine taxes have been going on for the 18 years that I've been studying the economy, and likely long before. Rightly or wrongly – Maine people believe we've got a problem with our tax system. So, how should we address the perceived problem?

Overhaul or Tune-up?

Bold Change or Band-Aid?

To answer these questions, I think we need to step back and ask some other, more fundamental questions...

- What is our vision for Maine?
- How far away from that vision are we?
- What role, realistically, can tax reform play in moving us toward that vision?

SLIDE 2: Vision

The Maine Economic Growth Council puts forth a vision for Maine that is:

“ A high quality of life for all Maine Citizens”

I believe that, ultimately, we all share this vision. Granted, a high quality of life means different things to different people, but in **NO** instance does it mean struggling for economic survival

SLIDE 3: National Rank on Per Capita Income

Let's start with some facts:

- Maine's Per Capita Income is perhaps the best overall measure of our economic health
- Our income has been growing - sometimes at a pretty good clip, but it has not kept pace with the U.S.
- And we have slipped from our peak of 27th in 1989 to 36th – where we seem to be stuck

The fact that in 4 of the past 5 years the Growth Council has assigned this indicator a red flag tells us that we are not making much progress towards achieving our vision and compels Maine leaders to take action.

SLIDE 4: Per Capita Income Gap

Further, the gap that separates Maine from the US has increased since 1989, nearly returning to the gap that we have long struggled with in prior decades.

In 2000, Maine's Per Capita Income was \$25,399

- Which is 14% below US average (\$29,451)
- And 35% below New England (\$38,824)

It's little wonder our young people are being lured across the border.

And about 1/3 of Maine jobs do not pay a livable wage (185% of Poverty level - \$20,792 – family of 2)

SLIDE 5: Productivity

One indicator we should examine in assessing our ability to generate wealth and to increase income levels is the productivity of our workers. The good news is – Maine's productivity has been growing for decades. The bad news is – our workers remain 80% as productive as the US average.

Does this mean Maine people are not as capable as others or don't work as hard?
ABSOLUTELY NOT!

It does indicate that we have not invested as fully as other states in:

- the education and training of our workers
- or in capital equipment and technology

which enables them to compete more effectively.

In order for Maine to fully participate in the knowledge-based, technology-driven economy and raise incomes, we must invest in:

1. Our people (education and training)
2. Our infrastructure
3. Our productive capacity
4. R & D (creation of knowledge)

There are 2 important roles for Government in investment

1. 1st, Government has a direct role in investing in
 - education and
 - infrastructure

So, Government must secure a sufficient and stable revenue stream to fund these critical investments

2. 2nd, Government has a less direct but essential role in creating a climate that is conducive to private investment in
 - capital equipment,
 - technology and
 - R&D

Since the primary source of Government revenues is derived from taxation, the tax system undeniably plays a role in determining economic vibrancy.

Please – let me make clear – right up front, in my opinion – to suggest that somehow altering our tax structure alone will close the income gap would be extremely misleading, but it would be equally misleading to suggest Maine's taxes are fine or to suggest that we can attain our vision without making some changes.

Taxes are part of the problem and need to be part of the solution

SLIDE 6: Productivity – Mfg vs. Non Mfg

One last note before we get into the principles of a good tax structure.

I would note that the value added to our economy for each manufacturing job is 50% higher than a non-manufacturing job, and productivity accelerated rapidly since 1995.

Is this a mere coincidence that 1995 is the year that the BETR program was put in place to counteract the investment disincentive created by the Personal Property on machinery and equipment?

- I don't think so!

SLIDE 7: Principles of Taxation

To assess the strength or weakness of Maine's tax structure we should start by examining the elements of a sound tax system.

Adam Smith's Maxims of Taxation included:

- Equality
- Certainty
- Convenience or Payment
- Economy

Henry George's Canons of Taxation suggested taxes should:

- Bear equally on citizens
- Be certain
- Be easily and cheaply collected
- And bear as lightly as possible on production

Today – I'll share a list of Principles from the Commonwealth of Massachusetts

I chose this list for a few reasons:

1st – This is the list developed by their special Commission on Tax Reform in the mid 80's

2nd – They used these principles (Simplicity / Fairness / Competitiveness / Cost Effectiveness / Neutrality / Stability / Exportability) in enacting some major tax reforms

3rd - They are now in the enviable position of having

- 2nd highest per capita inc in US
- 29th highest tax burden
- No longer can they legitimately be called “Taxachusetts”

Much could be said about each of these principles but I will focus on 2.

In February 1996 – Maine’s Economic Growth Council said

“Maine’s tax policy goal should be a State and Local tax system that is

- Broad based
- Generates stable and predictable revenues
- Yet does not impose burdens that place Maine at a competitive disadvantage.”

Obviously – these are trade-offs among these 7 principles

Daphne Kenyon – Chair of the Economics Department at Simmons College and author of a 1998 Report entitled “A Revenue Raising Plan for Maine” – hit the nail on the head in characterizing Maine’s struggle.

She said:

“No matter which tax options Maine’s voters choose, they will have tough choices to make regarding the conflicting goals of competitiveness and equality”

This strikes at the heart of Maine’s tax debates.

While all principles are important, it will be essential for us to prioritize and focus on a few.

SLIDE 8: State and Local Tax Burden

Like Massachusetts – I want to talk a bit of the competitiveness of our tax structure

Here’s the State and Local tax burden of a select group of states.

This is not, I repeat not, necessarily the best indicator of the competitiveness of our tax structure. In fact – it’s misleading because:

- Maine is a relatively poor state
- Maine is highly rural - with 22,000 miles of road to maintain
- Other states make greater use of fees which don’t show up in tax burden calculations
- Maine’s cold climate adds costs

And - even more importantly - a number of programs have been put in place to relieve the burden on businesses such as

- BETR
- TIF, ETIF, STIF, etc. making us more competitive

In fact, when you include all government fees with taxes, Maine's rank falls to the mid-teens. And in October 2001, Price Waterhouse Coopers completed the "State of Maine Tax Competitiveness Study" in which the tax liability of 7 representative firms was modeled for 12 different states, and Maine ranked fairly well, far better than these state level tax burden numbers would suggest

And herein lies the problem!

When any major examination of tax climate or business climate is done by magazines such as Forbes, Money, Financial World, we receive absolutely terrible publicity.

When site locaters prepare short lists, Maine doesn't make it into consideration.

When Maine business people hear this, they talk negatively about doing business in Maine.

And while we can explain away some of the burden, the fact remains – our taxes are too high, and that is hurting our economy.

As this chart shows, in 1999:

- Maine ranked #2 with a 13.5% burden
- Mass ranked #29 with a 10.5% burden
- NH ranked #50 with an 8.5% burden.

SLIDE 9: Maine vs. NE – Tax Burden

Further, while actual tax burden fell in Maine from 1998 to 1999, New England's burden fell more rapidly, increasing the gap that separates Maine from New England, from \$18 in 98 to \$25 in 99.

Noting that global markets are far less forgiving of high cost regions, I believe it's imperative for Maine to reduce the burden of taxes and revive competitiveness.

SLIDE 10: Volatility

In addition to competitiveness, the other principle on which I believe Maine needs to focus is stability. Stability means that annual fluctuations in revenues due to economic cycles should be minimized.

Just look at this picture! Look how even minor changes in income bring about revenue changes that are 2 to 3 times larger! Then humor me for a moment and pretend you are

the Chair of the State's Revenue Forecast Committee charged with predicting how nuances in the economy will impact revenues!! ☺ This is a nightmare!

Our sales tax base is far too narrow with 1/3 of sales taxes derived from sales of automobiles and building supplies. And the extreme progressivity and high marginal rate of our income taxes mean people rise rapidly through the brackets in good times and fall back down rapidly in bad times, creating huge revenue swings. In fact, I've recently learned that the top 2% of Maine income earners pay fully 1/3 of our Individual Income Taxes in Maine. 10,000 people pay over \$400 million dollars!

The problem with volatility is this: roller coaster budgeting cycles hamper the state's ability to make wise investment decisions. When the economy is good and tax revenues pour in, there is tremendous pressure to add new programs that we may not be able to afford in long run. When the economy contracts, revenues disappear and immediate cuts must be made.

We are put in position of
Cutting current services – with a face attached and immediate, noticeable consequences

Versus

Cutting a longer term program or goal on foundational items like

- Education
- Infrastructure
- BETR business incentives
- Technology

This delays or, worse, undermines progress in these critical areas.

SLIDE 11: Maine Tax Mix 2001

Finally, what is the appropriate tax mix for Maine?

Unfortunately, there's no perfect, guaranteed formula to apply.

A 1987 Tax Commission formed by Governor McKernan recommended that each of the top three taxes represent 25% - 35% of total collections and 10% from Special Revenues/Fees.

Using this guide, it appears we could offer relief to property taxes and income taxes with sales tax increases.

Conclusion:

So – back to the original questions:

Overhaul or Tune-up?

Bold or Band-Aid?

How?

To start the conversation today, I am going to share some ideas, but before I do– I must let you know the disclaimers:

1st – I continue to reserve the right to get smarter

2nd - I fully recognize the tremendous creativity and courage that Steve Levesque, Governor King and the Legislature have made over the past several years to address taxation issues and to ensure that at least some significant portion of our surpluses have been used to cover one time expenditures rather than on-going costs. Thank God they have or we'd be in a lot worse shape.

3rd - I understand that this will not be as simple as I'm going to make it sound.

SLIDE 12: BOLD

So, my vote – BE BOLD! It is my belief that the incremental approach has failed us.

Every major reversal of economic fortunes – Ireland / Michigan / North Carolina / Massachusetts - has been based on bold, in-your-face actions.

Here are my ideas, which primarily focus on 2 principles: stability and competitiveness.

FOR STABILITY

1. Tame the progressivity of the income tax
 - Not abolish it – tame it
 - Lower the top marginal rate
 - Re-adjust all brackets
 - Fully index to avoid creep
 - This will create greater stability
 - This will offer relief to 2/3's of Maine's businesses (the S-corps).
2. Broaden the sales tax base
 - To services
 - Maybe even to food
 - Eliminate exemptions
 - If necessary – raise rate to the national average of 6%.

I simply don't understand why we are afraid of this tax. It is the least distortionary of the three.

3. Consider Gross Receipts as an option (broader base and a lower rate).

4. Consider offering relief to capital gains taxes (to help to insulate us from stock market swings).
5. To counter the increased regressivity that is implied in some of the ideas above, add some progressivity to the property tax - by allowing differential tax rates for primary and secondary houses.

A recent report showed 15% of all housing units in Maine are second houses or vacation property, the highest in the nation.

FOR COMPETITIVENESS

6. Get rid of the personal property tax on machinery and equipment
 - It is absolutely an impediment to private investment
 - It places us at distinct competitive disadvantage
 - While BETR has struck at the heart of the problem, it ends up coming under fire every year creating ill-will, frustration and a “risky” investment climate.

BETR is not the problem, the tax is the problem. Get rid of it.

7. Absolutely must hold government expenditures in check

None of this will work if we allow spending to outstrip economic growth

- We must seek efficiencies
- We must battle costly patterns of development
- We must leave resources for long term investment

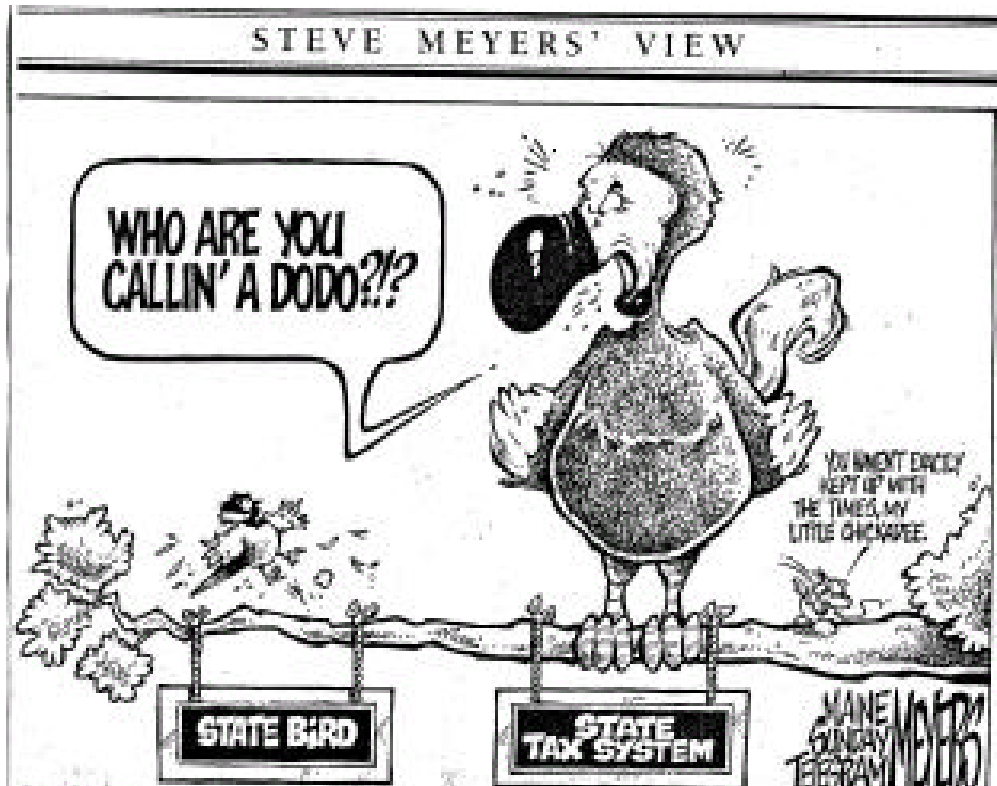
So – let’s be bold!

BUT...-Bold does not mean running roughshod!

- Bold must be backed with a thoughtful, comprehensive vision and a plan.
- Bold does not imply hasty/immediate action.
- Bold will likely require patience in implementation to minimize economic disruption.
- Bold, in my book, demands collaboration, to a degree we may not have seen before. No entity can accomplish this alone.

So, let’s be bold and for heaven’s sake – resist with every ounce of energy you can muster - the desire to chip away at bold proposals cuz when you chip away at bold – the “b” is the first letter to go and all you’re left with is OLD!

SLIDE 1



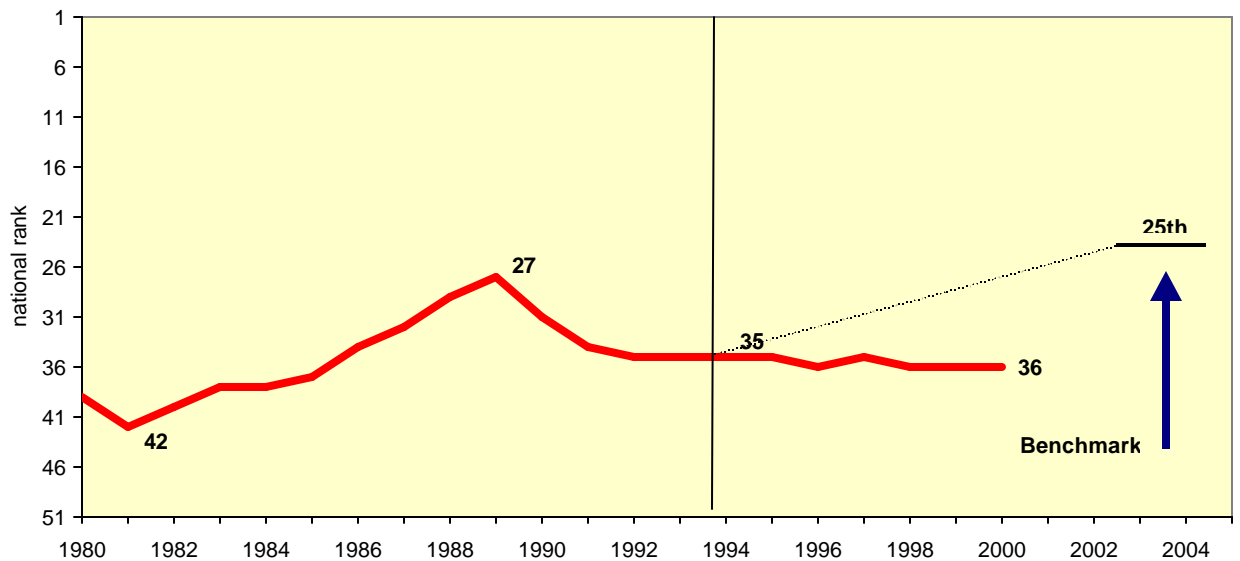
SLIDE 2

VISION

OUR VISION IS A HIGH
QUALITY OF LIFE FOR ALL
MAINE CITIZENS

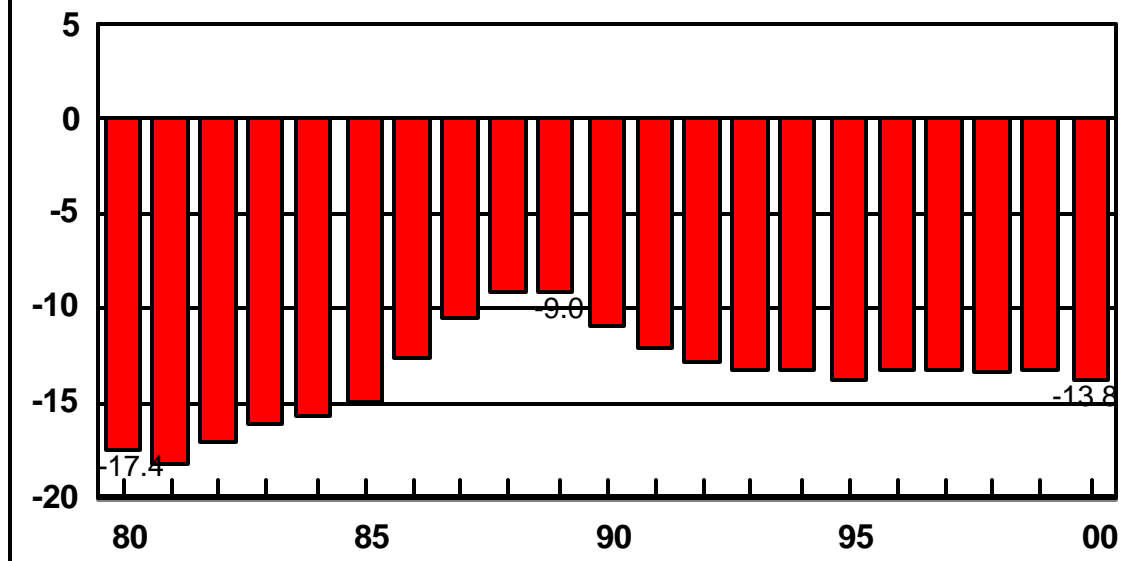
SLIDE 3

National Rank on Per Capita Income, 1980- 2000



SLIDE 4

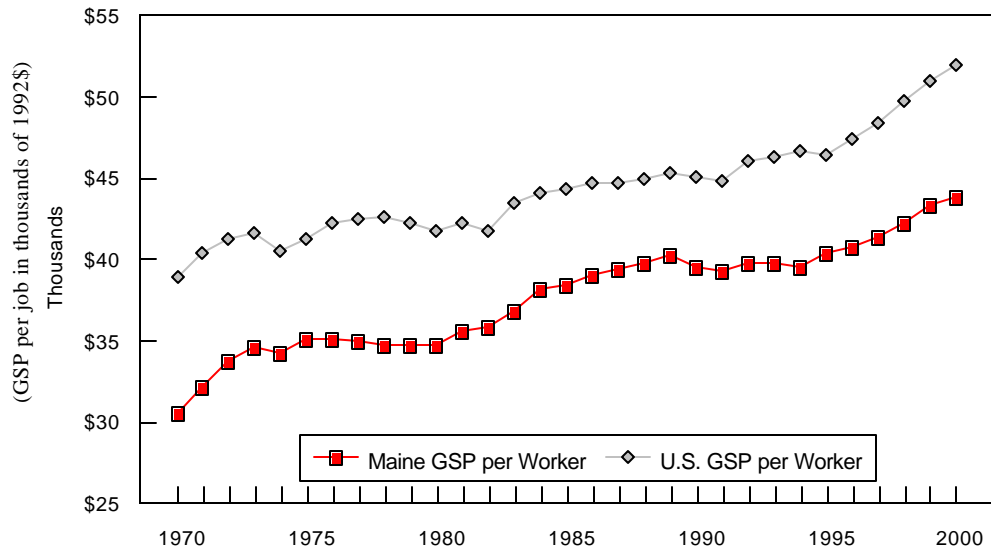
**Per Capita Personal Income
Percentage Points ME Lags US**



SLIDE 5

Productivity: REAL GSP per WORKER (Maine vs. U.S.)

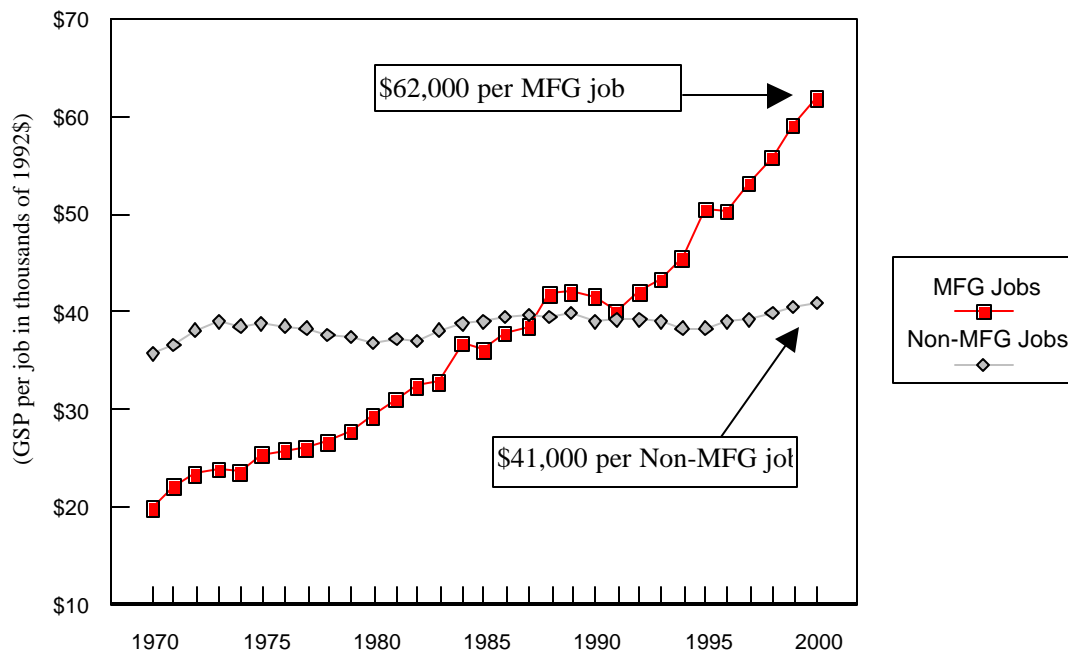
(economic contribution per job in thousands of dollars of real GSP per year)



SLIDE 6

Value of each MFG & Non-MFG job to Maine's Economy

(direct economic contribution per job in thousands of dollars of real GSP per year)



SLIDE 7

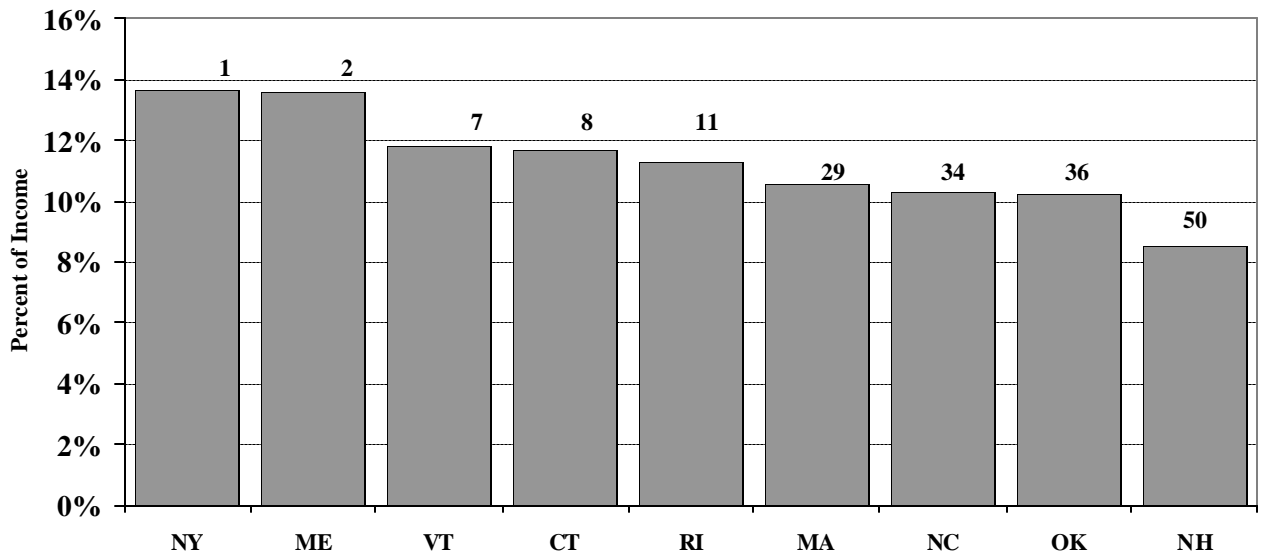
COMMONWEALTH OF MASSACHUSETTS

PRINCIPLES OF TAXATION

1. SIMPLICITY
2. FAIRNESS
3. COMPETITIVENESS
4. COST EFFECTIVENESS
5. NEUTRALITY
6. STABILITY
7. EXPORTABILITY

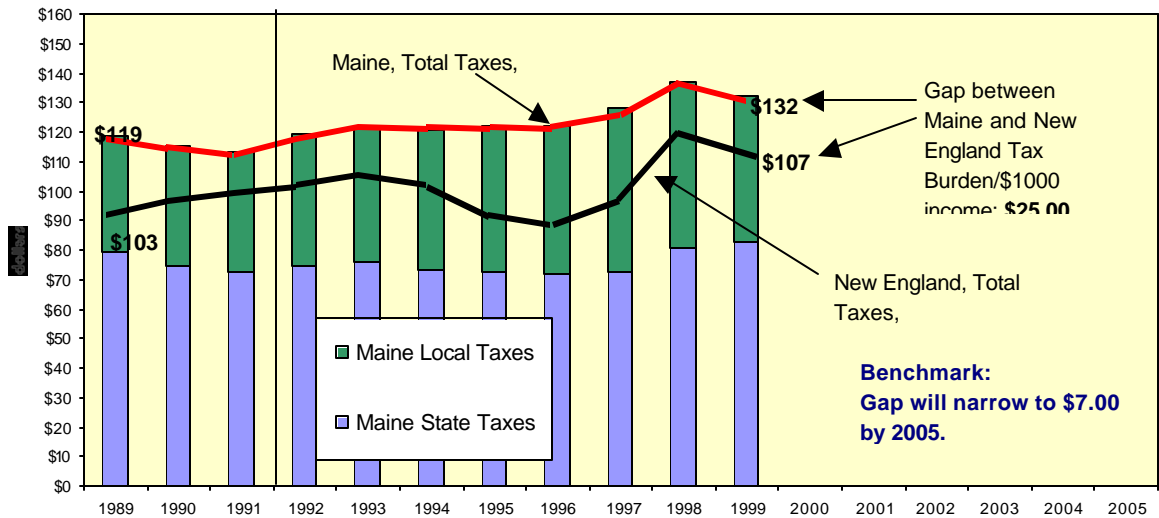
SLIDE 8

**Figure 14: Fiscal Year 1999 State & Local Taxes
as a Percent of Personal Income**



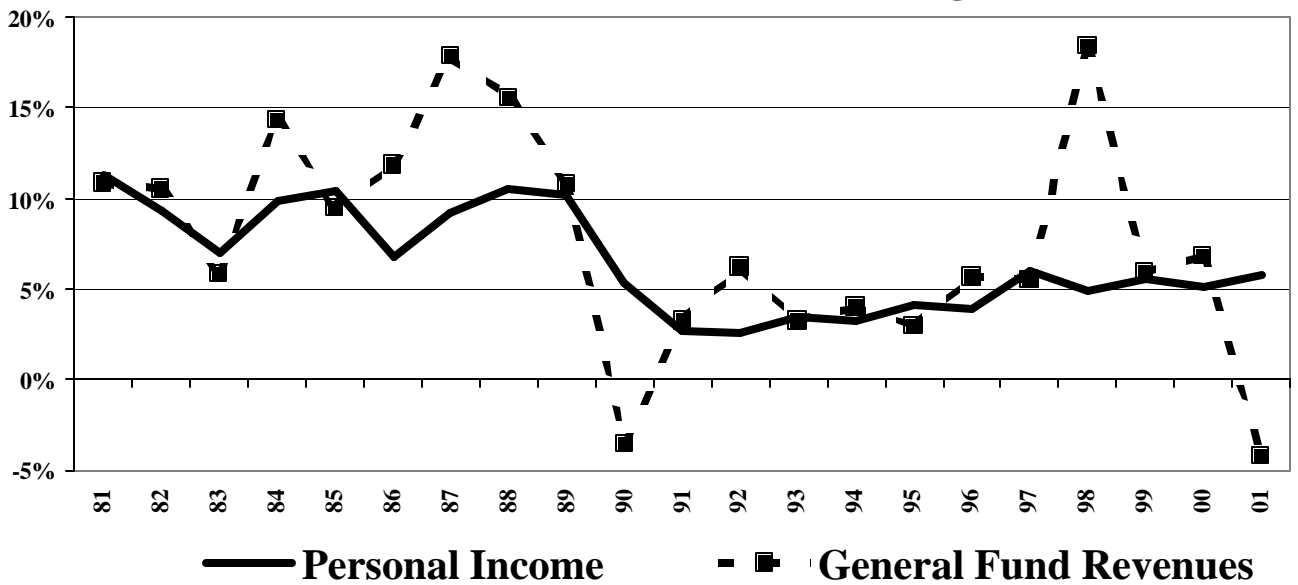
SLIDE 9

**Individual Tax Burden of all Taxes per \$1,000 Income
Maine and New England, 1989-1999**



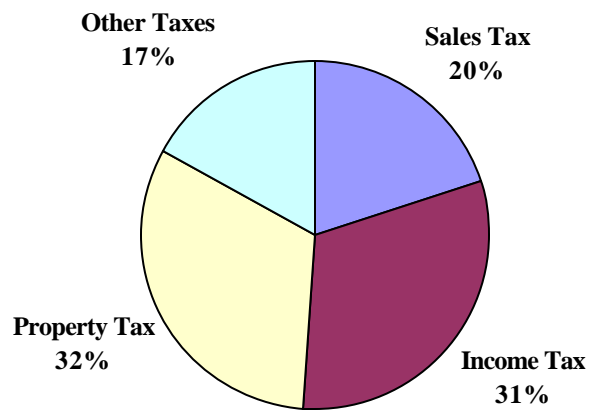
SLIDE 10

**Maine Personal Income & General Fund Revenue
Fiscal Year to Fiscal Year Percent Change**



SLIDE 11

Maine's 2001 Tax Mix



SLIDE 12

BOLD!